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SUBJECT: PAKISTAN'S BANKS FACE DETERIORATING CONSUMER AND SMALL BUSINESS PORTFOLIOS, PROTECTED FROM GLOBAL CREDIT CRISIS

REF: LAHORE 0014

¶1. (SBU) Summary. The banking sector in Pakistan has been largely shielded from the international financial crisis by a regulatory framework that has limited its foreign currency and securities exposure. Although there were no major losses in calendar year 2008, local bankers are expecting problems to surface in the troubled consumer and small business loan sectors in the coming months. The high interest rates (required by the IMF Standby Arrangement), while still lower than inflation, have hit the troubled textile sector - which accounts for over 20 percent of the banks' portfolio - particularly hard. Banks are working out payment schedules with customers to prevent large defaults, but several large corporations are in serious trouble. Lowering inflation, and consequently interest rates, is critical to Pakistan's speedy economic recovery. Local interlocuters are expecting at best a stagnant rate of growth for FY 2009, rather than the 3 percent predicted by the Government of Pakistan. End Summary

¶2. (SBU) Local banking representatives have given us a pessimistic picture for the coming year, in particular for their small business and consumer loans (which account for over 40 percent of banks' portfolios). Although there have been no major losses or defaults in Calendar Year 2008, it appears that this will change in 2009. Over the past several years, credit grew by over 25 percent annually, with a corresponding decline in the creditworthiness of borrowers. These at times marginal borrowers have been hit hard by rising interest rates. With a 15 percent discount rate, banks routinely charge 20 or 21 percent interest; in a country where the average per capita income is under $1,000, repayment is becoming difficult.

¶3. (SBU) As lending to large corporate entities became less profitable, banks diversified into the commercial and small and medium enterprise (SME) sector, which now accounts for about one third of their portfolios. SME's are traditionally thinly capitalized and have low operating margins. Textile companies in the SME sector, such as knitwear, bed linens, and home textiles, depend on bank borrowing for their working capital, and have been extremely hard hit. With profit margins of only 9-10 percent, they have been unable to repay their working capital loans at the end of a product cycle (which banks normally require), and have been running up ever larger balances. Eighty percent of one large bank's textile loans have been downgraded. Even large companies are in trouble. One local source believes that Dewan Salman Fiber, LG Electronics, and Chenab Textiles may be close to default [protect].

¶4. (SBU) That the banking sector is not even more troubled is largely due to effective regulation by the State Bank of Pakistan (SBP), according to one local banker. Capital adequacy ratios were raised to nine percent, and banks now average 13 percent. When the SBP raised capital requirements recently, many smaller banks were forced to merge, while those with foreign parents received capital injections. (The SBP plans to increase the minimum capital requirement again, to $300 million by 2013.) Since banks are not allowed to borrow offshore and are required to hedge their open foreign currency positions with the SBP, they were not exposed to foreign exchange risk as the rupee plummeted in value. The SBP also limits banks' exposure to equities to less than 15 percent of their capital, which has shielded them from the recent stock market volatility.

¶5. (SBU) Comment. The monetary tightening required by the IMF's Standby Arrangement, as well as the GOP's previous extensive borrowing (which has crowded out the private sector), have had a debilitating impact on Pakistan's small businesses - especially in the perennially troubled textile sector, which is also battling high energy prices and declining demand. The banking sector will have to monitor its portfolio over the next two or three quarters carefully and work out payment arrangements with its troubled customers to avoid large numbers of defaults. Until inflation is brought under control, with a corresponding drop in interest rates, the manufacturing sector in Pakistan will continue to struggle, and a robust recovery will be unlikely.

PATTERSON